IT 96-7
Tax Type: INCOME TAX
Issue: Business/Non-Business (General)

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	)	
	)	
v.	)	No.
	)	FEIN: XXXXX
	)	TYE: 3/31/86-3/31/89
INTERNATIONAL TAXPAYER, INC., et al.,	)	
Taxpayer	)	

RECOMMENDATION FOR DISPOSITION

Appearances: Mr. Fred O. Marcus, of the firm of Horwood, Marcus & Braun, and Mr. Paul Frankel, of the firm of Morrison & Foerster, for the taxpayer; Mr. Colin Relphorde, Special Assistant Attorney General, for the Department of Revenue.

Synopsis:

This case arose as a result of two audits of International Taxpayer, Inc. ("taxpayer"), under the auspices of the Illinois Income Tax Act, **35 ILCS 5/101** *et seq.* for the combined periods of 3/31/86 through and inclusive of 3/31/89. At issue is the propriety of reclassification by the Department of interest income from arbitrage activities of taxpayer from non-business to business income and subjecting it to apportionment under specific provisions of the Income Tax Act and departmental regulation. As an adjunct to this issue is the question of whether taxpayer is entitled to alternative relief under Section 304(f) of the Act, (**35 ILCS 5/304(f)**) if the income is appropriately classified. Finally, taxpayer asserts that "reasonable cause" exists by which to abate penalties imposed under Section 1005 of the Act, (**35 ILCS 5/1005**).

The case was submitted upon a joint stipulation of facts, various exhibits and affidavits for the tax years ending 3/31/86 and 3/31/87. For the subsequent years of 3/31/88 and 3/31/89, both stipulated facts and testimony were admitted. Upon consideration of the evidence and a review of the record, it is recommended that the first two issued be resolved in favor of the Department and that the third be resolved in favor of taxpayer.

Findings of Fact:

1. The *prima facie* case of the Department was established by the stipulated admission of DOR exhibits A through I, for the years ending 3/31/86 and 3/31/87 and DOR exhibits A through O for the years ending 3/31/88 and 3/31/89. The affidavit of (Manager) was accepted into evidence for taxpayer. (Stipulation)

2. Taxpayer is an (Out of State) company, incorporated in 1954. Its headquarters are located in (City A) and it maintains offices in twenty cities throughout the United States. (Stipulation)

3. Taxpayer is an international general trading company. It imports, exports, buys, markets and distributes a wide variety of consumer and industrial products, as well as technology and services.

4. Taxpayer's trading business is comprised of the following seven trading groups:

a) Information Systems and Services Group, - high technology products relating to information and communications systems and technology;

b) Fuels Group, - crude oil, petroleum products, gas and carbon materials and products;

c) Metals Group, - steel products, ferrous raw materials and non-ferrous metal;

d) Machinery Group, - heavy machinery, automobiles and mass production goods;

e) Foods Group, - food commodities, foodstuffs and restaurant related products;

f) Chemical Group, - commodity chemicals and plastics;

g) Textiles and General Merchandising Group, - textiles, lumber and pulp and general merchandise.

5. Taxpayer maintained several Illinois offices during the period in issue, which were engaged in the following activities: 1) Commodities trading by the Metals, Machinery, Chemical and Textiles Groups; and 2) Mobile Communications.

6. Taxpayer has a centralized management and support system for its seven trading groups. They include centralized departments for: 1) traffic and insurance; 2) planning and coordination; 3) accounting; 4) investment and credit; 5) legal; 6) information and telecommunications systems; 7) finance; and 8) general administration.

7. The seven trading groups have a formalized procedure for obtaining approval for their daily transactions. The approval process applies to each transaction for each trade division. The areas for which approvals are required are: a) establishment of lines of credit; b) release or amendment of lien, security interest, mortgage or other encumbrance; c) operating transactions for commodity and/or freight; d) conclusion of agency or distribution contracts; e) selection of company for transportation warehousing; f) settlement of claims; g) extension of time for customer payments; h) writing off, settlement or restructure of bad debts; i) filing, answering and/or settling law suits or arbitration; j) acquisition or disposal of stock; k) acquisition or disposal of fixed assets; l) loans and guarantees; m) business plans for subsidiaries; n) withdrawal from investments; o) country risks.

8. A worldwide policy of stringent checks and balances regarding management decisions of the trading divisions exists for each of the seven trading groups. However, there is no such policy for the arbitrage group. (Tr. p. 43; Dept. Ex. "M")

9. An arbitrage is a self-contained process whereby a small group of people borrow money from one source at a fixed rate of interest and loan the money to another source at a higher fixed rate of interest. The difference in the interest rate is the profit to the arbitrage. (Tr. p. 18)

10. The arbitrage group here was comprised of five employees of taxpayer, and had been operating since the early 1980's. The group consisted of (Manager), manager of the Capital and Money Market ("CMM") Department and the Finance Department of the Finance Division of taxpayer, and four other employees of the CMM and Finance Departments. (Tr. pp. 51-55)

11. The arbitrage group operated out of an office in (City A) and their duties were to raise funds for the arbitrage and to invest and monitor the funds for profit. (Tr. pp. 22-28)

12. The arbitrage group raised funds ($20 million) by taxpayer issuing commercial paper in the name of taxpayer at the market rate (e.g. 3%). (Tr. p. 59) The funds were invested by the arbitrage group in long-term securities such as certificates of deposit that yield a higher rate of interest (e.g. 3.4%), to realize a percentage profit. The only source of funds for the arbitrage group were derived from the issuance of the commercial paper by taxpayer and not from the working capital of taxpayer. (Tr. pp. 22-29; 59)

13. To accomplish the arbitrage, the manager of the CMM Department contacted investment bankers and others to identify suitable investment vehicles which would provide a return greater than the cost of commercial paper taxpayer issued. When an investment opportunity is found, the investment vehicle (usually a floating rate note) is purchased and a corresponding amount of commercial paper is simultaneously issued to raise the funds to cover the purchase price. The purchase price of the investment and the issuance of the commercial paper are matched by the employees of the arbitrage group. (Manager affidavit, par. 11)

14. When the floating rate investment matures, the amount received is used to repay the commercial paper issued to finance the investment. The balance or deficiency after repayment represents the profit or loss. (Manager affidavit, par. 12)

15. The commercial paper used to finance the investments made by the CMM Department, is issued by Taxpayer Finance Department. (Manager affidavit, par 14) The initial financial stability of the arbitrage group came from the "long standing name of Taxpayer" and the purchasers of the commercial paper relied on taxpayer to assure them of a return on their investment. (r. pp. 31-33; 59-60)

16. Prior to April 1, 1988, the function of the CMM Department and the Finance Department were totally integrated. A separate CMM Department was created April 1, 1988 in order to improve the monitoring of the performance of the arbitrage activity. (Manager affidavit, par. 15)

17. The arbitrage group was not subject to the daily transaction-by-transaction approval or review process as were the other divisions of taxpayer. (Tr. pp. 40-41; 61) The only review of the arbitrage activities occurred when taxpayer's executive committee reviewed the activity reports filed by the manager of the arbitrage group on a semi-annual basis. (Tr. pp. 53-55) The executive committee also had the authority to terminate the arbitrage activity. (Tr. pp. 43-45)

18. The arbitrage group had limited investment authority. Approval from the general manager of the Finance Division was required in the event the arbitrage group invested in financial instruments in excess of $10 million. Such approval was given

orally on occasion to the manager of the arbitrage group by the general manager of the Finance Division, who was located outside of Illinois. (Tr. pp. 33-37; 61)

19. The arbitrage interest or funds earned and realized were coded to its source and deposited into the general funds account and combined with the general funds of taxpayer. (Tr. pp 28; 33-35; 56) The interest income from the arbitrage activity was separately logged and accounted for by the CMM Department in taxpayer's general fund account and categorized differently than the income and expenses of the other trading divisions. The general fund was used to fund the operations of the other trading divisions. (Tr. pp. 35-37; 56) (Manager affidavit; par. 20)

20. The Finance Department of taxpayer financed the trading activities through the Cash Management and Cashiers ("CMC") Department. In the event a trading group required working capital, a request was made to the Finance Department through the CMC Department, not the arbitrage group. The CMC Department was responsible for the maintenance of taxpayer's working capital requirements. Each trading group advised the CMC Department of its cash needs on a daily basis, twenty-four hours in advance. If the CMC Department had sufficient funds to meet the requests, they were satisfied with available working capital. In the event additional funds were required to finance the daily operations of the trading groups, the CMC Department requested the Finance Department to raise the funds through the sale of commercial paper, medium terms notes or through bank borrowing. The uncommitted working capital funds of the CMC Department were usually invested in overnight transactions. (Manager affidavit, par. 17)

21. The interest income from the excess working capital for such transactions as indicated above, is separately accounted for and not included in or related to arbitrage activity interest income. Income earned by the Finance and CMC Departments was reported to Illinois and other jurisdictions as business income. (Tr. pp. 24; 45-47) (Manager affidavit, pars. 17, 18)

22. No one in the arbitrage group was involved in the trading activities conducted by taxpayer in Illinois. (Tr. pp. 24, 48) No one in taxpayer's regular trading business groups had any involvement with the arbitrage group except for the finance manager. (Tr. p. 23) There was no operational link between the arbitrage group and taxpayer's regular trading businesses.

23. During the years at issue, taxpayer reported the income earned by the arbitrage group to the State of (A), its commercial domicile, as well as (City A), and paid the taxes due thereon. (Tr. p. 64)

24.. In each of the tax years in question, taxpayer reported income earned from the arbitrage activities as "non-business income" on IL-1120 forms filed for those years in the State of Illinois.

25. Taxpayer relied upon its own counsel and tax preparers (Company B)) as to the reporting of the arbitrage income as non-business income. Taxpayer was advised by its tax preparers that the income should be excluded by reasons of decisions by the United States Supreme Court in ASARCO, Inc. v. Idaho State Tax Comm., 458 U.S. 307, 102 S. Ct. 3103 (1982) and F.W. Woolworth Co. v. Taxation and Revenue Dept. of Mexico, 458 U.S. 354, 102 S.Ct. 3128 (1982).

Conclusions of Law:

Section 1501(a)(1) of the Illinois Income Tax Act, 35 ILCS 5/1501(a)(1), defines "business income" as follows:

> The term 'business income' means income arising from transactions and activity in the regular course of the taxpayer's trade or business... and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations...

Non-business income, under the terms of Section 1501(a)(13), constitutes all income which is not business income.

Under the provisions of 86 Ill. Admin. Code, Ch. I, Sec. 100.3010(a) (formerly Section 100.3050(a)), "business income" is further classified, in pertinent part, as follows:

> ...A person's income is business income unless clearly classifiable as nonbusiness income... Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of trade or business operations...

Under the regulations, the critical element in determining whether income is "business income" or not, is the identification of the transactions and activities which are the elements of a particular business. In general, all transactions and activity which are dependent upon or contribute to the operations of the economic enterprise as a whole will be transactions and activity arising in the regular course of a trade or business.

In determining whether income is business income under the statute and regulatory definition, there are two alternative tests which must be applied. The two separate tests are commonly referred to as the "transactional" and "functional" tests. If either test is met, the income will constitute business income. *See* National Realty and Investment Company v. Department of Revenue, 144 Ill. App. 3d 541, 494 N.E. 2d 932 (2nd Dist. 1986); Dover Corporation v. Department of Revenue, 271 Ill. App. 3d 700, 648 N.E. 2d 1089, 1097 (1st Dist. 1995). A taxpayer has the burden of proving that a particular item of income is non-business income. National Realty, *supra*.

Under the *transactional test*, income will be classified as business income if it is attributable to a type of business transaction in which the taxpayer regularly engages. The emphasis here is whether the income arises from the "regular course" of the taxpayer's business, and as such, the relevant inquiry looks to the nature of the particular transactions and the forms or practices of the business activity.

Under the *functional test*, income will be classified as business income if the acquisition, management and disposition of the property constitutes an integral part of the taxpayer's regular trade or business operations. Under this test, the extraordinary nature or infrequency of the transactions are irrelevant. Moreover, it is not necessary that the business transaction be in the course of a taxpayer's regular trade or business, but that it be in the regular course of the taxpayer's trade or business operations. The focal point, then, is whether the income constitutes an "integral part" of the business activities of the taxpayer.

The Department asserts in its brief that under the facts in this case, both the functional and transactional tests have been satisfied and that the taxpayer has failed to overcome the presumptions accorded by showing that interest payments constitute non-business income.

Taxpayer, on the other hand, contends that the interest income from the activities of the arbitrage group is income that arose from transactions and activities not in the regular course of Mitsubishi's trade or business and particularly unrelated to activities in Illinois. The income, it argues, results from isolated transactions and the activities of an autonomous division of the company that operated out of (City A) and which did not contribute to the operations of the taxpayer as a whole. The dissolution of the arbitrage group would have no impact upon the operations of this taxpayer either within Illinois or outside of this State.

Taxpayer further contends that the Illinois statute distinguishes between the business and non-business income of a non-domiciliary taxpayer. Business income of a non-domiciliary corporation is apportioned, but non-business income is allocated to the state of commercial domicile or to the geographic origin of the income. Therefore, the arbitrage income must be allocated to (State B) because: 1) the income is non-business; 2) the commercial domicile is (State B); and 3) the income was earned in (State B). (Taxpayer brief, p. 12)

Applying the tests to the evidence of record, I can find no clear demonstration that the income of the arbitrage group was non-business. Taxpayer is an international trading company which imports, exports, buys, markets and distributes a wide variety of commodity, consumer and industrial products, as well as technology and services. It has seven diversified trading groups and is profoundly known and recognized in the world as a sound and profitable corporation.

In order to operate, the arbitrage groups only source of funds was derived from the issuance of commercial paper, by taxpayer itself through its own finance department, at a certain interest rate. The initial and continued financial stability of the arbitrage group came from the long standing name of taxpayer, and the purchasers of the commercial paper heavily relied on that company to assure them of a return on their investment. The funds raised were then invested by taxpayer into another security that yielded a higher rate of interest. The income from the arbitrage activities is a function of both the raising of capital to be applied to the other trading groups and to the actual trading of the arbitrage group.

Clearly this operation is no simple passive investment as the taxpayer may allude. Taxpayer is engaged in the issuance of its own commercial paper as an integral part of a systematic and consistent activity in the regular course of its business. It utilizes the commercial value of its corporate name and employs the services of its own financial department to complete the necessary transactions. The arbitrage activities are dependent upon the commercial paper operations and the interest income from the arbitrage activities contribute in significant fashion to the economic enterprise of the company as a whole. This is particularly true since taxpayer reinvests the interest income into the general funds of the company which in turn support returns earned by investors of the commercial paper.

This taxpayer has not, by any stretch, established that the commercial paper issued by (its own) finance department, which generates the arbitrage interest income is not held or created in the regular course of business operations or that the purpose of the issuance of the commercial paper is not integral to its business operations.

In arguing that the disputed income is non-business, taxpayer characterizes the business income analysis in terms of the extent to which the arbitrage group's activities are involved in the trading activities and operations of the other trading groups. It contends that the arbitrage activities are completely separate and independent from other trading business. However, I believe the finding that the income is business income is consistent with the analysis of the court in Dover, *supra*, and other similar decisions.

In Dover, the Illinois Appellate Court reviewed the question of whether income from royalties was business income under the statutory definition and whether the taxpayer had met its burden of proof in demonstrating that it was not. The royalties in question were generated from unrelated parties and were derived from two sources, *viz*. licenses for the use of Dover's technology in foreign markets not served by Dover, as well royalty income received as a result of patent infringement recoveries. Dover, 648 N.E. 2d at 1096. Dover's arguments sought to narrowly define what constitutes its business within the statutory definition of "business income". In the first category, Dover argued that its business was that of a manufacturer, not a licensor of intangibles for use overseas. It further argued that it did not have the ability to engage in business in the foreign markets to which it licensed the technology from which the royalties were derived. In the second category, Dover claimed that as a manufacturer, the filing of patent infringement litigation was not part of that business and the technology which was the subject of the patent infringement was unrelated to Dover's unitary business.

The court found that both categories of royalties were business income and rejected the defensive position Dover had taken. In the court's rationale, it ruled that royalty income was related to Dover's manufacturing business and both the licensing of developed technology and the enforcement of patented technology were elements of that business because of the benefits received.

In the present matter, taxpayer strives for a narrow reading of what constitutes business income by posing that arbitrage activities are not transactions conducted in the regular course of business by the trading groups. This stand ignores, however, the fact that the activities of the arbitrage significantly contribute to the operations of the taxpayer as a whole.

In an unreported case, the Circuit Court of Cook County found business income to exist in circumstances similar to what is presented here. In the matter of Howard Johnson Company v. Department of Revenue, 81 L 4368 (1982), the court ruled that income from an investment fund used partly as a working capital reserve constitutes business income because the acquisition, management and disposition of the fund constituted an integral part of the taxpayer's trade or business.

The investment fund at issue in Howard Johnson was created using earnings from the company's business operations, the exercise of employee stock options and a public offering of common stock. It consisted mainly of U.S. Treasury obligations and the fund grew to over $80 million in 1978. During the applicable tax years (1971, 1973 and 1974), no more than 22 percent of the money

was used as working capital. The company claimed that the portion of the fund not used as working capital represented a discrete business venture not connected with taxpayer's economic activities in Illinois.

Rejecting that position, the circuit court specifically noted that the fund consisted of short term securities reflected as working capital in the balance sheets and shareholder reports. It was reasoned that such a presentation basks Howard Johnson's management in the "financial glow of its stability". Observing further that the same financial officers which control the hotel and restaurant business also controlled the fund as to acquisition and utilization, the court found substantial evidence to conclude that the utilization of the entire fund was a related, integrated aspect of the unitary business.

In taxpayer's case, the purchasers of the commercial paper issued in the name of the company rely on the good name and strong financial standing of taxpayer, not the arbitrage group, to assure them of a return on their investment. Moreover, the profits garnered from the investment income of the arbitrage group inure to the benefit of the company as a whole. The profits of the arbitrage group are deposited in the company's general fund, which in turn are utilized to finance the activities of the other trading groups of taxpayer. These facts do not suggest a "discrete" business venture unconnected to taxpayer's economic activities in Illinois.

As a secondary matter, taxpayer presents the claim that treating the arbitrage profits as business income under the Act is precluded by the limitations which the due process and commerce clauses of the United States Constitution impose on the State of Illinois' power to tax. I reject such position in its entirety.

The United States Supreme Court, in the case of Allied Signal, Inc. v. Director, Division of Taxation, 504 U.S. --, 112 S.Ct. 2251 (1992), reviewed the issue of when an item of income may be constitutionally included in apportionable income. The court reaffirmed the validity of the principle that if an item of income is derived as part of a unitary business, a state need not attempt to isolate the intra-state income producing activities from the rest of the business. Unless the income is derived from unrelated business activity which constitutes a discrete business enterprise, a state may tax an apportioned sum of a corporation's multi-state business if it is unitary in function.

The Court in Allied Signal went on to state that companies need not be engaged in a unitary relationship as a prerequisite in order for income to be subject to apportionment. It was emphasized that the existence of a unitary relationship is only one means of meeting constitutional requirements for apportionment. In doing so, the Court clarified the focus of its analyses applied earlier in both ASARCO, Inc. v. Idaho State Tax Commission, 458 U.S. 307, 102 S.Ct. 3103 (1982), and F.W. Woolworth Co. v. Taxation and Revenue Dept. of New Mexico, 458 U.S. 354, 102 S.Ct. 3128 (1982). It required that the transaction serve an operational rather than an investment function. Allied Signal, 112 S.Ct. at 2263-64 (citing Container Corporation of America v. Franchise Tax Board, 463 U.S. 159, 103 S.Ct. 2933, 2948, n. 19 (1983)). Under the Supreme Court's determination then, the income here may be excluded from

apportionment only if taxpayer proves that the income was earned in the course of activities unrelated to those carried out in the State of Illinois.

On the record before me, the argument that the activities of the arbitrage group were not part of a unitary business related to activities in Illinois is unconvincing. More important, however, is the fact that the constitutional requirements for apportionment do not depend upon the existence of a unitary relationship between taxpayer and the arbitrage group, the payee of interest income, because the payor of the interest income is a third party. All that is required here is that the transactions serve an operational, rather than an investment function. *See* Allied Signal, 112 S.Ct. at 2263.[1]

Although the arbitrage group operated exclusively from the (City A) office and only had a few select employees, it was by no means an autonomous operation. The group members were all employees of taxpayer's financial department and the head of the group managed the Finance Division of taxpayer. The Finance Division in turn is the self same entity that issued the commercial paper which financed the arbitrage group's activities as well as the activities of the other trading groups.

The record here clearly demonstrates that taxpayer, through the issuance of its commercial paper by its finance department and the arbitrage group, was engaged in transactions of a systematic and recurrent business practice which benefitted the company as a whole. The interest income from the arbitrage group was deposited into the general operating account of taxpayer in order to fund its entire world-wide operations.

Without the combination of the issuance of taxpayer's own commercial paper which was backed by its long-standing financial stability and the expertise of the group comprised of employees from the financial department, the interest income from the transactions would most likely not have been as successful or as profitable. The transactions undertaken by the arbitrage group were, without doubt, performed in an effort to strengthen the operations and business of taxpayer as a corporate entity. Therefore, the income earned arose from transactions in the regular course of business as well as constituting an integral part of taxpayer's business operations and is apportionable.

As a final matter, I find the statement made that termination of the arbitrage group's activities would have "no impact" on the other trading groups or the State of Illinois (Tr. P. 25; Manager affidavit, par. 16) to be disingenuous. While the arbitrage group in comparison to the company as a whole might well be compared to a flea on an elephant, the loss of millions of dollars in profit which would otherwise be used to finance the operations of other trading groups within the company cannot be said to be inconsequential.

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[1]. Taxpayer cites a finding in the circuit court opinion of Dover, in support of its argument (Taxpayer's Brief, pp. 32-33). *See* Dover Corporation v. Department of Revenue, Paragraph 400-640, CCH Illinois Tax Reporter, Circuit Court of Cook County, 91 L 50730 (August 17, 1993). This was the unappealed portion of the circuit court case dealing with capital gains and interest income where the court made a finding of non-business income. Although this portion of the decision was not appealed by the Department, the facts in this segment of the case are dissimilar to those of taxpayer. The income in dispute in Dover involved capital gains from the Schroeder fund and interest income from Eurodollars. Unlike what exists here, there was found to be no operational relationship between those funds and the taxpayer's business. The income in Dover derived from the Schroeder and Eurodollar investments were from funds which were in a passive, long-term investment of non-working capital bearing no relation to Dover's unitary business.

While its loss would certainly not "bring down the ship", so to speak, termination of the arbitrage group and its investment activities would surely be felt, even if it meant no more than a minor irritation. The bottom line, however, is that the interest income from arbitrage does confer a unitary benefit, otherwise there would be no purpose in its continued operation.

Section 304(f) Relief:

In the alternative, taxpayer poses that if the arbitrage income is found to constitute business income subject to apportionment, the amounts should be considered as income earned from a separate trade or business. All such income should thus be handled under separate accounting and alternative apportionment.

Taxpayer contends, as part of its petition for relief under Section 304(f) of the Act, 35 **ILCS** 5/304(f), and comparative regulations, that applying the normal apportionment formula results in distortion rising to the constitutional level. This is so, it argues, because improper consideration has been given to the property involved in the arbitrage activities or the receipts therefrom. The natural consequence of this situation is entitlement to factor representation.

Generally, Section 304(a) of the Act directs that multistate corporations doing business in Illinois must apply a three-factor apportionment formula, based on property, payroll and sales, when apportioning business income to this State. Where utilization of this formula does not "fairly represent" the extent of a taxpayer's business within Illinois, certain adjustment may be made in the formula under the requisites of Section 304(f).

The terms of Section 304(f) are as follows:

> Alternative allocation. If the allocation and apportionment provisions of subsections (a) through (e) do not fairly represent the extent of a person's business activity in this State, the person may petition for, or the Director may require, in respect of all or any part of the person's business activity, if reasonable:
>
> (1) Separate accounting;
> (2) The exclusion of any one or more factors;
> (3) The inclusion of one or more additional factors which fairly represent the person's business income; or
> (4) The employment of any other method to effectuate an equitable allocation and apportionment of the person's business income.

Departmental regulations as set forth in 86 Ill. Admin. Code, ch. I, Sec. 100.3390(c)[2] (formerly Sec. 100.3700(a)(4)), further provide in part:

> ...This subsection permits a departure from the required methods applicable under *** Section 304(a) through (d) *** only where such methods do not accurately and fairly reflect business activity in Illinois. *An alternative apportionment method under this subsection may not be invoked, either by the Director or by a taxpayer, merely because it reaches a different apportionment percentage than the regularly required formula.* However, if the application of the statutory formula will lead to a *grossly distorted result in a particular case*, a fair and accurate alternative method is appropriate. *** The party (the Director or the taxpayer) seeking to utilize an alternative apportionment method has the burden of showing by clear and cogent evidence that the statutory formula would result in the taxation of extraterritorial values. *** The burden will be met only if the statutory formula is demonstrated to operate *unreasonably and arbitrarily in attributing to Illinois a percentage of income which is out of all proportion to the business transacted in this state.* *** Finally, the party seeking to use an alternative apportionment formula must prove that such method fairly and accurately apportions income to Illinois based upon business activity in this state. (emphasis added)

To justify utilization of an alternative formula in a particular case, the application of the statutory formula must therefore reach a *grossly* distorted result. Some distortion alone is insufficient. The simple fact that applying an apportionment method other

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[2]. Effective November 1, 1993

than that which is statutorily required may result in a higher (or perhaps lower) amount of income subject to taxation is of no legal significance. In upholding the burden of proof upon the taxpayer, the Illinois Supreme Court in the case of Citizens Utilities Co. v. Department of Revenue, 111 Ill. 2d 32, 488 N.E. 2d 984 (1986), held that a taxpayer must prove distortion by clear and cogent evidence and that such burden is not met by reliance on bare percentages alone.

Applying the basic standard to the facts of this case, I can ascertain no clear and cogent basis to conclude that alternative relief under Section 304(f) is in any way appropriate. In reaching this decision, I have carefully considered the testimony of the taxpayer's "expert" witness, a partner at (Company B) and a specialist in state and local taxes, and find it less than persuasive.

John Doe testified concerning the factor representation analysis he conducted for the 1988-89 tax years and his opinion regarding Section 304(f) factor relief is based upon that review. In general, it was his opinion that the property and sales factors should be modified to reflect the value of the intangible property involved in the arbitrage activities and the receipts generated by them. This position is based on the theory that the three-factor formula has not given any effect to the underlying assets and activities that generate the income by the arbitrage group. (Tr. p. 91). His conclusion is that unless the adjustments are made, Illinois is essentially taxing income earned outside the state. However, it is noted that John Doe's opinion is based, in its entirety, upon the assumption that arbitrage activity is a separate and distinct activity within taxpayer. (Tr. pp. 89, 91, 120)

Taxpayer's Section 304(f) adjustment to the property factor seeks to adjust the denominator to include the "average value of securities held throughout the year" by the arbitrage group. (Taxpayer Ex. Nos. 2; 3) Intangible property is not included in the property factor under Section 304(a)(1) of the Act - only real and tangible personal property are. John Doe testified that taxpayer originally filed including rented property, real property owned and tangible personal property owned. (Tr. p. 82) He affirmed that the proposed adjustment was computed by determining during the year the average value of commercial paper in the arbitrage activity. (Tr. p. 82)

The proposed alternative by this taxpayer further seeks to vary the denominator of the sales factor to include gross receipts on the sale of securities. (Taxpayer Ex. Nos. 2; 3) Section 100.3380(c)(5), (formerly 100.3700(c)(5)) of the Department's regulations deals with the sale of business intangibles such as stocks and other securities. Pursuant to that regulation, only the gains from the sale are included in the sales factor. Per Mr. Doe, taxpayer originally filed using the net receipts on their returns. (Tr. p. 84) The proposed adjustment was computed by determining the gross proceeds from the turnover of securities that were actually sold during the year. The turnover of those securities was determined by calculating gross sales of commercial paper that took place during the year.

These proposed adjustments are inconsistent with the objective of the standard three-factor formula. That formula attempts to divide income among states where the income is earned by a multi-state business. It is accomplished by including within the formula those business activities (i.e. property, payroll and sales) which produced the income that is to be apportioned.

The payroll and property factors seek to measure the physical presence of a business within the state. For example, in the case of the arbitrage group, the payroll factor would reflect taxpayer employees responsible for the investment transactions and the property factor would reflect the offices where those transactions were conducted. The sales factor, on the other hand, gives weight to the share of the applicable market of the state which is controlled by the business enterprise.

The suggested revision to the property factor proposed by taxpayer's witness would be inconsistent with the legislative approach of the three-factor formula. The inclusion of an average net book value of the taxpayer's marketable securities would act to distort the amount of property because intangible property has no physical presence in *any* state. The property factor does not include intangibles in the apportionment formula in order to avoid precisely that problem.

So, too, would the suggested revisions to the sales factor be inconsistent with the three-factor approach. Rather than measuring market activities, taxpayer's computation is dependent, in part, on the amount of turnover. This in turn does not bear a relationship to the reflection of taxpayer's income or even the actual amount of income of the arbitrage group. Moreover, to go beyond inclusion of net gains by inclusion of gross receipts in the sales factor would actually serve to *create* a distortion in the denominator. This is true because of the fact that the company has a huge amount of gross proceeds in relation to its disposition of net gains and interest income. Since taxpayer realized over $2 billion in proceeds in each of the taxable years from the turnover of the commercial paper, inclusion of those proceeds would disparately inflate the sales factor.

On the record before me, other than the bare argument that trading activities are separate from arbitrage activities, taxpayer has not proven its actual income from Illinois transactions. The record presents no basis for comparing the taxpayer's Illinois income under an alternative apportionment method and that determined under the three-factor formula. At best, the suggested method urged by taxpayer reaches a more favorable percentage than the required statutory formula and a consequently lower tax liability. However, simply showing a different, alternative or even better method of apportionment than the three-factor approach does not meet the statute and regulatory mandate of demonstrating a *gross* distortion from such usage. There is no clear and cogent evidence here that Illinois is taxing extraterritorial values by what the taxpayer has presented.

Section 1005 Penalty:

Pursuant to Section 1005 of the Act, 35 **ILCS** 5/1005, the Department has proposed the imposition of a penalty upon this taxpayer for its failure to pay the amount of tax required to be shown on its returns as filed. taxpayer, in response to that proposal, submits that the penalty should be abated due to the existence of "reasonable cause".

Looking to the statutory provision, the applicable penalty section reads as follows:

> ...If any amount of tax required to be shown on a return prescribed by this Act is not paid on or before the date required for filing such return (determined without regard to any extension of time to file), a penalty shall be imposed at the rate of 6% per annum upon the tax underpayment *unless it is shown that such failure is due to reasonable cause.* This penalty shall be in addition to any other penalty determined under this Act. (emphasis added)

From such language, it is clear that a penalty will not be imposed where it is shown that "reasonable cause" formed the basis for a taxpayer's failure to pay what is due.

For tax years ending prior to January 1, 1994, the Department of Revenue had no guidelines nor had it enacted any operative regulations as to exactly what constituted reasonable cause in the determination of whether or not to exact a penalty on errant taxpayers.[3] For that reason, Section 1005 penalties were viewed in light of federal case law dealing with reasonable cause, which in turn was usually interpreted as having taken a "good faith" position on a filed return. *See* I.R.C. Section 6664(c).

Under the federal guidelines, the general rule of thumb is that if there is an honest difference of opinion as to the application of fact or law regarding the correct amount of tax, no penalty will be imposed. See, e.g. Ireland v. Commissioner, 39 T.C. 978 (1987); Webble v. Commissioner, 54 T.C.M. 281 (1987).

On the basis of the record before me, I believe adequate evidence has been presented which demonstrates that an honest difference of opinion exists between the Department and taxpayer as to the position taken on its returns. Reliance upon the considered opinion of their accounting firm who in turn based their interpretation on the court decisions in ASARCO and Woolworth, *supra*, is the exercise of ordinary business care and prudence.[4] Accordingly, the proposal to impose a penalty under section 1005 would be inappropriate in this instance.

It is therefore recommended that:

1) The Notices of Deficiency for the respective tax years ending 3/31/86 through 3/31/89 should be upheld in their entirety as the reclassification of interest income from arbitrage activities as business income is proper;

2) The petition for alternative apportionment under the provisions of 35 ILCS 5/304(f) should be denied as no clear and cogent evidence of gross distortion has been presented;

3) The proposed penalty under 35 ILCS 5/1005 should be withdrawn due to the existence of reasonable cause.

Administrative Law Judge

2/20/96

[3]. The Department has now adopted regulations on what constitutes reasonable cause relating to the Uniform Penalty and Interest Act [35 ILCS 735/3-1 et seq.] See Part 700, Uniform Penalty and Interest Act, Subpart D. Under Section 700.400 of the regulations, the most important factor to be considered in making a determination to abate a penalty will be the extent to which the taxpayer made a good faith effort to determine its proper tax liability. This parameter is considered to have been met if the taxpayer exercised ordinary business care and prudence in filing their returns.

[4]. While the cases cited may not be dispositive of the issues since the ruling of the court in Allied Signal v. Director, Division of Taxation, 504 U.S. --, 112 S.Ct. 2251, they were, at the time, persuasive authority.